No. 95-301 AUG 17 1995

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In The

SUPREME COURT
OF THE UNITED STATES
October Term, 1995

STONEHENGE INSURED NOTES-I LIMITED PARTNERSHIP; AND HARBISON-FISCHER MFG. CO., INC., *Petitioners*,

v.

UNITED STATES DEPARTMENT OF THE TREASURY, STATE OF NEW YORK, and PHILIP ZINKE, *Respondents*.

Petition for a Writ of Certiorari
to the United States Court of Appeals
for the Second Circuit

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August 1995

QUESTIONS PRESENTED

1. Whether an admitted fiduciary under ERISA who admittedly self-deals with ERISA plan assets, may avoid liability because the ERISA plan beneficiaries do not meet a burden of proof imposed by the trial court, to trace the plan assets for purposes of imposing the equitable remedies of restitution and constructive trust.

2. Whether an investment manager who admits he is an ERISA fiduciary to ERISA plans and their affiliated entities (limited partnership) has the burden of proof to justify his admitted self-dealing with plan assets.

3. Whether ERISA plans and their affiliated entities (limited partnership) have the burden of proof under ERISA to show tracing of assets for imposition for the equitable remedies of restitution and constructive trust, despite admitted self-dealing with plan assets by an admitted fiduciary.

4. Whether an admitted ERISA fiduciary is liable as a non-fiduciary under ERISA for equitable remedies of restitution and constructive trust for a knowing breach of the ERISA prohibition against self-dealing.

5. Whether an admitted ERISA fiduciary may terminate his fiduciary relationship to an ERISA plan and its affiliates without an express unambiguous communication to the ERISA plan or its affiliates.

LIST OF PARTIES

Petitioner, Stonehenge Insured Notes-I Limited Partnership

Petitioner Harbison-Fischer Manufacturing Co., Inc., is a wholly-owned subsidiary of Harbison-Fischer, Inc., a Delaware corporation

The United States Department of the Treasury

The State of New York

Respondent Philip W. Zinke wholly defaulted in the lower court proceedings, but appeared at trial in the bankruptcy court.

Judith A. Zinke, Goodman Plumbing and Heating Corp., Robert Abrusso, Strazzen & Son, Environmental Control Board, V.A. Paradise, and John and Jane Does no longer have an interest in the outcome of the petition for certiorari

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Stonehenge Insured Notes-I Limited Partnership, and Harbison-Fischer Mfg. Co., Inc., respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, B-1) is unreported. The opinions of the district court (App., *infra*, C-1, D-1) are unreported. The Findings of

Fact and Conclusions of Law of the bankruptcy court (App., *infra*, F-1) are unreported. The opinion of the bankruptcy court on the Motion for New Trial (See App., *infra*, E-1) is reported at 149 Bankr. Rptr. 310 (E.D.N.Y.1992).

JURISDICTION

The court of appeals entered its judgment on January 10, 1995 (App., *infra*, B-1). The court of appeals denied a timely filed Motion for Rehearing with Suggestion for Rehearing *In Banc* on May 19, 1995 (App., *infra*, A-1). The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTORY PROVISIONS INVOLVED

29 U.S.C. §1002(21)(A) provides that

> A person is a fiduciary with respect to a plan to the extent
>
> (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,
>
> (ii) he rendered investment advise for a fee or other compensation, direct or indirect, with respect to any monies or other property of such plan, or has any authority or responsibility to do so, or

(iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

29 U.S.C. §1104(a) 29 U.S.C. Sec. 1104(a), provides in relevant part:

(1) ... [A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and--

(A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are

consistent with the provisions of this title or title IV.

29 U.S.C. Sec. 1109, provides:

> (a) Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary. A fiduciary may also be removed for a violation of section 411 of this Act.
>
> (b) No fiduciary shall be liable with respect to a breach of fiduciary duty under this title if such breach was committed before he became a fiduciary or after he ceased to be a fiduciary.

STATEMENT OF THE CASE

The jurisdiction of the bankruptcy court was invoked under 28 U.S.C. 1334 and 157 (a) and

(b)(2)(A), (B), (N) and (O). The jurisdiction of the district court was invoked under 28 U.S.C. 158(a). The jurisdiction of the court of appeals was invoked under 28 U.S.C. 158(d).

Petitioners sued Philip Zinke and his wife for constructive trust arising from Zinke's misapplication of funds from Stonehenge and Harbison-Fischer in purchasing a personal residence for Zinke. Philip Zinke was an investment advisor and broker who was subsequently convicted of serious unrelated crimes.[1] Zinke solicited money from multiple investment clients over a period of years, for

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[1] People v. Zinke, 147 A.D. 106, 541 N.Y.S.2d 986 (1st Dept. 1989, reversed as to criminal liability, 76 N.Y.2d 8, 556 N.Y.S.2d 11 (1990); U.S. v. Zinke, et al., 92 Cr. 899 (PNL), U.S. Dist. Ct. S.D.N.Y. 1991. In August, 1987, Zinke was convicted after a jury trial in New York State Court on two counts of grand larceny "for embezzling $1.05 million in mid-1984 from Stonehenge." People v. Zinke, 541 N.Y.S.2d 986. The conviction was affirmed by the Appellate Division, First Department, but reversed by the Court of Appeals on the technical ground that as a matter of law the general partner of a limited partnership cannot be charged with the crime of larceny from the limited partnership. People v. Zinke, 556 N.Y.S.2d 11 (1990). Although Zinke escaped criminal liability, Zinke admitted the $1.05 million has never been returned or repaid.

investments for the clients' ERISA qualified pension funds. Without the clients' knowledge or consent, he used several million dollars of the clients' money to purchase a personal residence and a commercial building, for his personal use.

Philip Zinke was the general partner of Stonehenge. Zinke was the investment manager of the H-F pension plan. H-F's pension plan was a limited partner in Stonehenge. Zinke was an ERISA fiduciary to Stonehenge. No evidence was presented to contradict the status of Zinke as a fiduciary to Stonehenge.

After his scheme was partially uncovered, the victimized investment clients, including Petitioners Stonehenge and H-F, sought to recover their money by seizing the personal residence.

Zinke's wife filed bankruptcy and obtained an order from the bankruptcy court with jurisdiction of her case allowing the residence to be sold free and clear of liens, but subject to the constructive trust claims of Petitioners. Internal

Revenue Service and the State of New York appeared in the bankruptcy court in support of the sale of the personal residence free and clear of liens. Zinke's wife asked the bankruptcy court to allow payment of IRS and the State of New York, pending resolution of the constructive trust claims. The bankruptcy court authorized payment of the tax claims, subject to the court's later determination that the constructive trust claims were valid and requiring the tax authorities to refund the tax payments.

Petitioners proved their money was used by Zinke on the personal purchases, but Zinke claimed he legally "borrowed" the money and any profit on the deals was his to keep (and to pay his personal taxes) even though Stonehenge remains unpaid.[2]

Zinke failed to disclose these transactions to anyone involved in Stonehenge (including H-F).

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[2] Unless otherwise stated, references to the trial transcript are to August 5, 1991.

Stonehenge asserted Zinke embezzled the money, and breached his fiduciary obligations to Stonehenge. Zinke claims it was a loan he as the general partner for Stonehenge made to himself and that he had the right to "self deal."

Zinke pointed to written notes signed after the money was used by him as evidence of his "loan" from H-F. He admitted he never told H-F of his plan to use the money for his personal purchase because "it's not any of their business." One year after receiving the funds, Zinke represented in writing to the outside auditors for Petitioner H-F that the funds were invested as the client originally understood, and said nothing about his personal purchase.

The Bankruptcy Court found that Zinke's status as a common law and ERISA fiduciary to the victims over several years, did not prevent him from engaging in side deals with the Petitioners, even though he did not tell them he was not acting in a fiduciary role in the side deals with them.

The Bankruptcy Court held that the Petitioners had the burden of proof on the case and did not meet it. The Court also stated "if the burden was on the other side I could possibly rule the other way."

The Bankruptcy Court held that H-F was paid back on the personal residence "loan," and Stonehenge had no remedy against the Apartment sale proceeds even though the so-called loan repayment to H-F came from funds on which Stonehenge had a claim. In effect, the Bankruptcy Court held that Zinke's tax authorities had a higher priority claim than either of the Petitioners.

The District Court upheld the Bankruptcy Court's decision because the burden of proof was on Petitioners to do so on a basis of "clear and convincing evidence."

The statement at the oral argument to the bankruptcy counsel by counsel for Stonehenge that Stonehenge could not "trace its funds to the co-op, but only to H-F," was in error and not a waiver of

the evidence presented at the trial. Zinke admitted that Stonehenge funds were used to purchase the commercial building. Zinke asserted that H-F was paid out of the proceeds of the commercial building refinance. While Petitioners continue to except to the assertion by Zinke, even if Zinke's assertion is deemed true as found by the bankruptcy court, Zinke's testimony clearly traces Stonehenge funds to the personal residence transaction. In other words, the only way that H-F could have been repaid on the personal residence transaction was for Stonehenge's interest in the commercial building to have been substituted for H-F's interest in the personal residence. As a result, Zinke was robbing Peter to pay Paul.

Upon timely appeal to the United States Court of Appeals for the Second Circuit, the Second Circuit affirmed the lower court opinion, and specifically stated that the burden of proof was on the Petitioners to prove tracing and the elements of the constructive trust.

Each of the lower courts ignored the admission by Zinke that he was an ERISA fiduciary to the H-F pension plan and other pension plans that were limited partners of Stonehenge Insured Notes. Zinke also admitted that he was the general partner of Stonehenge, and that he used Stonehenge funds and H-F funds to purchase his personal residence. Zinke claimed that his use of H-F funds was permissible because the funds were loaned to him by H-F. The bankruptcy court held that the transaction between H-F and Zinke was a loan. Zinke claimed that he was not a fiduciary to H-F in connection with the loan despite his admitted fiduciary status to H-F's pension plan.

Each of the lower courts held that no tracing of assets from Stonehenge to the Zinke residence was proved by the Petitioners. No contention was ever made by any party to the case that Zinke communicated a termination of his fiduciary

relationship to Stonehenge, H-F, nor any other limited partner of Stonehenge.

REASONS FOR GRANTING THE PETITION

I. Fiduciary and Non-Fiduciary Obligations under ERISA

The opinions of the lower courts in this case eviscerate the public policy to protect ERISA beneficiaries and participants from fraud and self-dealing by ERISA fiduciaries. This case provided a strong test of the application of the fiduciary obligations of ERISA to a case in which the fiduciary admitted self-dealing with qualified plan assets.

In Mertens v. Hewitt Associates, 508 U.S. 113, 113 S. Ct. 2063, 124 L. Ed.2d 161 (1993), the Court stated that ERISA makes fiduciaries liable for breach of fiduciary duties, including avoidance of conflicts of interest, and self-dealing Mertens v. Hewitt Associates, 508 U.S. 113, 113 S.Ct. 2063, 124 L.Ed.2d 161, 167 (1993), and

> specifies the remedies available against them: the fiduciary is personally liable for damages. . . for restitution ('to restore to [the] plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary'), and for 'such other equitable and remedial as the court may deem appropriate,' including removal of the fiduciary. §502(a)(2), 29 U.S.C. §1132(a)(2).

Mertens, 124 L.Ed.2d 161, 167.

At the same time, the majority opinion in Mertens reserved for determination the issue of whether ERISA imposed liability for a non-fiduciary's participation (knowing or unknowing) in a fiduciary's breach of fiduciary duty. Mertens, 124 L.Ed.2d 161, 169.

As a result, this case presents an opportunity to determine whether a non-fiduciary is subject to equitable relief under ERISA, and further to delineate under ERISA the fine line between fiduciary obligations and the obligations of a non-fiduciary.

Petitioners firmly believe that Zinke was a fiduciary both to Stonehenge and its component limited partners, including H-F's pension plan, but also to H-F itself as the plan sponsor of H-F's pension plan.

Even if Zinke was determined to be a non-fiduciary with respect to the funds he acquired from H-F, Petitioners assert that he was liable as a party-in-interest and a non-fiduciary for knowing participation in a breach of his fiduciary duties with respect to Stonehenge funds.

II. The Decision of the Court of Appeals is Erroneous

Cases interpreting ERISA have uniformly held that the burden of proof is on a fiduciary to prove his conduct proper after a threshold showing of blatant fiduciary misconduct, such as self-dealing with plan assets. See Marshall v. Snyder, 572 F.2d 894 (2nd Cir. 1978), in which the court made it clear that the party representing plan beneficiaries who challenges a fiduciary's conduct in a

transaction in self-dealing does not have the burden of proving the unfairness of the transaction, and the burden of proof is on the fiduciary to the transaction where self-dealing is alleged. Also see Donovan v. Cunningham, 716 F.2d 1455, 1467-1468 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1983), Whitfield v. Lindemann, 853 F.2d 1298 (5th Cir. 1988). Also see Donovan v. Bierwirth, 754 F.2d 1049 (2nd Cir. 1985). In Leigh v. Engle, where fiduciaries benefitted from the improper use of plan assets, the court required the fiduciaries to meet the burden of tracing the profits which were attributable to their own investments and which were attributable to plan assets. Leigh v. Engle, 727 F.2d 113, 138 (7th Cir. 1984). Finally, the Second Circuit held in New York State Teamsters Council Health and Hospital Fund v. Estate of DePerno, when a plan showed fiduciary violations, even if no losses due to those violations were shown, the burden shifted to the defendant fiduciaries who had allegedly breached their duty,

to demonstrate that the expenditures were reasonably necessary and that the value received at least equalled the sums paid." New York State Teamsters Council Health and Hospital Fund v. Estate of DePerno, 18 F.3d 179 (2nd Cir. 1994).

III. The Court of Appeals' Interpretation of the Burden of Proof under ERISA

The Court of Appeals' interpretation of the burden of proof under ERISA conflicts with other circuits' interpretations, and other cases within the Second Circuit. The cases cited above all conflict with the Court of Appeals' opinion in this case. The Petitioners request for in banc consideration was denied below.

The interaction of the Mertens opinion with Lowen v. Tower Asset Management, Inc., 829 F.2d 1209 (2nd Cir. 1987), may be a cause for interpretative concern by the Court of Appeals for the Second Circuit. Therefore, this case presents an opportunity for the Court to resolve the differences between the circuits in light of the

Mertens case, and to further define the principles underlying Mertens and the unanswered issues presented thereby.

IV. The Questions Presented are Important

ERISA was passed by Congress out of concern that pension funds "were being corruptly or ineptly mismanaged and that American workers were losing their financial security in retirement as a result." Mertens, 124 L.Ed2d 161, 175, dissenting opinion of Justice White.

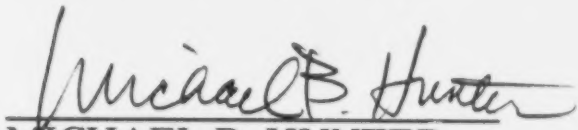
Congress enacted ERISA "to protect . . . the interests of participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect [to the plan], by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, and ready access to the Federal Courts." 29 U.S.C. §1001(b). Mertens, 124 L.Ed.2d 161, 175.

Fiduciary obligations, or the denial of such obligations, are critical components of the economy and citizens' well-being. As the citizenry ages and becomes focused on retirement funding, establishing more definite standards for conduct of fiduciaries or non-fiduciaries with respect to retirement funds is a critical need. If liability should attach, then establishment of the rules for such conduct will enhance that aspect. If ERISA's broad provisions should not be expanded to non-fiduciaries, a clear indication of that determination will avoid clogging the courts with unwarranted claims against non-fiduciaries.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,



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